

recognizes this relevant fact, the proposal ignores it.^{43/} Second, to the extent the Commission attempts to fashion a method "to produce lower rates for consumers" Comcast believes it does so in derogation of its duty to balance investor and consumer interests. Third, the Commission fails to distinguish between costs and value. Typically, under regulation the distinction is not meaningful, if it exists at all. In the free market, however, the distinction is critical. Goods and services sell at market clearing prices that are in no way tied to a seller's original or net book cost. The cost is sunk and does not dictate the price.^{44/}

The NPRM proposes to exclude part of system acquisition price in excess of the original cost of cable plant insofar as the sums would not be recognized either as an expense or as part of the ratebase from which the operator could earn a return.^{45/}

^{43/} NPRM at ¶ 22.

^{44/} Comcast submits that once a system has changed hands the cost or price to the original builder is not relevant to the "costs" of providing cable service. The Commission must recognize that for existing businesses the "cost" is the net investment in tangible and intangible assets as of the date on which regulation took effect. Alternatively, the Commission could define "original cost" in terms of the imposition of regulation (as opposed to the time of construction). The Commission has defined original cost as "the actual cost of property when it was first dedicated to use by a regulated telecommunications entity." Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Common Carriers, 4 FCC Rcd 1697, 1703 (1989). In that context, the cost and value of the system are synonymous. The property of a cable operator was not dedicated to use by a regulated entity until April 5, 1993 (the date on which the FCC adopted its rate freeze), therefore the unrecovered investment as of that date could be considered the original cost.

^{45/} The NPRM observes, however, that its proposed approach "does not necessarily preclude recovery of excess acquisition costs . . . to the extent we permit excess
(continued...)

The NPRM defines "excess" acquisition costs as the price paid for an enterprise as an ongoing business that exceeds the value of plant in service. The Commission believes that prices paid for cable systems included a premium reflecting an expectation of monopoly earnings.^{46/} The NPRM proposes to exclude these sums from the regulated ratebase, including those sums assigned to intangibles such as going concern value, customer lists, and franchise rights. The NPRM seeks comment on the potential impact of this proposal on the cable industry, subscribers and lenders.

The Commission's proposal is inconsistent with its obligations under the 1992 Cable Act and with constitutional requirements. The Commission has failed to establish that any operator paid an unlawful amount or is otherwise not entitled to the recovery of and return on its investment. Indeed, the Commission stated that even though market prices have exceeded the "value (original cost) of the plant in service,"

^{45/} (...continued)
acquisition costs to be included in [the] ratebase or amortized over a specified number of years." NPRM at ¶ 35.

^{46/} NPRM at ¶ 36.

such costs were not necessarily "excessive" or "imprudent."^{47/} Similarly, the Court in Bluefield noted:

[I]n the absence of peculiar and extraordinary conditions such as . . . the erection of a plant at an actual, although extravagant, cost, or the purchase of one at an exorbitant or inflated price, the actual amount of money invested is to be taken as the basis, and upon this a return must be allowed equivalent to that which is ordinarily received in the locality in which business is done, upon capital invested in similar enterprises.^{48/}

Whether too much has been paid is a factual question to be decided on a case-by-case basis. A price paid cannot be deemed excessive in the abstract; a comparison to some other relevant known price or measure is required. The purchase prices of cable systems relative to their book values were not inconsistent with the relationship of price to book for other comparable companies acquired during the same period.

The Commission's proposal ignores what the buyer of a cable system bought from the seller. In addition to the physical plant, the buyer of an ongoing cable business acquires programming interests, a customer base, a franchise, and a trained and in-place workforce. Additionally, buyers often purchase cable systems with the expectation of developing new services which, combined with potential increases in management efficiency, provide opportunities to increase significantly the customer base and value of the acquired system. Cable systems that traded in recent years

^{47/} NPRM at ¶ 36 and n.40.

^{48/} Bluefield, 262 U.S. at 689 (emphasis added).

were valued primarily on these critical factors, not on the original cost of the cable plant.

The Commission's proposal not to include the entirety of a cable operator's unrecovered investment in a system also ignores the benefit that an acquisition may provide to subscribers. The Commission's proposal is based on the theory that subscribers benefit only from plant in service. This theory, however, fails to consider the increased level of customer service and satisfaction that often follows an acquisition.

A key factor that determines the price an operator pays to acquire a system is the potential to increase the system's customer base and value. An operator may be willing to pay more than the book value of the assets of the system if the operator believes that it can employ the assets more productively than the previous owner. Recent press accounts cite this as one reason AT&T agreed to merge with McCaw Cellular and pay a price far in excess of McCaw's book value.^{49/} When, for example, the acquiring party can operate the system at a lower cost than the previous

^{49/} See John J. Keller, AT&T Agrees to Buy McCaw Cellular in Stock Swap Valued at \$12.6 Billion, Wall Street Journal, August 17, 1993, at A3. Reportedly, though McCaw's assets exceed its liabilities by about \$1.4 billion, AT&T paid stock worth about \$12.6 billion for McCaw. See Floyd Norris, Market Place, N.Y.

owner, the acquirer may provide equal or better service at a lower price, thereby creating the potential to increase system value.^{50/}

Frequently, an acquiring MSO is able to provide better service through efficiencies, including those attributable to its structure, size or proximity to the acquired system. These efficiencies include, among others, the ability to manage systems on a regional level, and to obtain programming and equipment discounts and lower insurance rates. The benefit that an acquisition may provide to subscribers has been recognized by many state commissions, and the Commission has no basis to assume that this is not true for cable acquisitions.^{51/}

The Commission's tentative decision to value cable plant at original cost and to exclude "excess acquisition" costs from the ratebase is contrary to sound economic thinking and is unnecessary.^{52/} Moreover, by its action the Commission takes issue with regulatory bodies that recognize the entire investment in a system as appropriate.

^{50/} Growth of a system could be affected, for example where the operator is constrained in his ability to provide quality service at a reasonable price. An operator that acquires the system may be better situated to introduce new services and provide subscribers with a better value in terms of the price paid and the quality and quantity of service received. As the Tax Court observed, "the poor reputation of an existing franchisee often works to the buyer's advantage because the buyer then has the opportunity to improve the system." See, Tele-Communications, Inc. v. Commissioner, 95 TC 495 (1990).

^{51/} See, e.g., Re Peoples Gas Systems, Inc., 119 PUR4th 252 (1990); see also, Bonbright at 241.

^{52/} Furthermore, in many cases original cost information is simply not available. In the case of acquired systems assets are valued at the time of acquisition, the seller's records are rarely retained. Even if available, the seller's records may not depict the original cost of the system as adjusted to the time of purchase.

The Securities and Exchange Commission, the Internal Revenue Service, and other government agencies accept the amount paid or invested as the actual cost basis for a system.^{53/} This approach makes absolute sense; the buyer purchased tangible and intangible assets of some consequence as part of an ongoing business.

An exclusion of investment, including debt incurred to finance improvements, unreasonably denies cable operators recovery of their prior investments. At a minimum, regulation must ensure that a system, over its economic life, recovers its investment, earns returns needed to attract capital in the future, and generates revenues to cover expenses. The Commission's proposal does not reach this minimum threshold.

IV. THE COMMISSION MUST ADOPT A TRANSITIONAL RATEMAKING METHODOLOGY FOR SYSTEMS THAT MUST JUSTIFY THEIR INITIAL RATES UNDER REGULATION.

A. There Is Regulatory Precedent for a "Transition" Period Definition of Ratebase Under a New Regulatory Environment.

The NPRM correctly recognizes the potentially severe impact of its proposed ratebase methodology on cable operations. As the NPRM observes, one approach to

^{53/} Internal Revenue Code Section 1012 ("The basis of property shall be the cost of such property."); see also, MacKenzie v. U.S., 714 F. Supp 268 (E.D. Mich 1989) (the depreciable basis of property purchased in an arms-length transaction is the cost of property, even where the cost exceeds the fair market value of the property).

recognizing and accounting for the effect of introducing regulation is to establish a transition period.^{54/}

In times of massive changes in market structure or fundamental shifts in regulatory policy, it is common for regulatory bodies to reject the "flash-cut" introduction of new rules and cushion the impact of rules on regulatees (severe reductions in revenues) or the public (dramatic increases in prices) by adopting transition mechanisms or phasing in new policies. Such an approach is required in this case. An immediate across-the-board adoption of the Commission's proposed rules would have a devastating impact on the financial viability of cable systems that must justify their initial rates.

As the NPRM recognizes, other regulatory agencies have adopted transitions for industries that are initially regulated or subjected to a new regulatory regime.^{55/} For example, when regulatory authority over oil pipelines was shifted from the Interstate Commerce Commission to the Federal Energy Regulatory Commission a transition period ratebase was explicitly recognized.^{56/} Similarly, the Tax Reform Act of 1986 (the "TRA"), which eliminated the Investment Tax Credit for property

^{54/} NPRM at ¶ 22. Conceptually, the Commission could neutralize the infirmities of its proposal by allowing recovery of intangibles and step-up basis for physical plant. The NPRM, however, does not provide sufficient specificity to give notice of the methods to be employed, their relationship to current rates, and their effect on investor interests.

^{55/} NPRM at p.13 n.21.

^{56/} Williams Pipeline Co., 31 FERC ¶ 61,377 (Opinion 154-B) (1985).

placed in service after December 31, 1985, included transitional rules to protect the expectations of taxpayers that had made substantial investment commitments under the prior regime.^{57/}

The Commission also has abundant experience with transition rules. For example, in the early stages of interstate long-distance competition the Commission approved interexchange carrier negotiated access charges that reflected an interim rate differential to account for AT&T's superior access to the local network. Under this interim agreement (the Exchange Network Facilities for Interstate Access or "ENFIA"), AT&T's competitors paid access charge rates that were lower than those paid by AT&T through the division of revenue process.^{58/}

In its implementation of interstate equal access, the Commission continued to use rate differentials and phasing-in of access charge rate parity as a transition mechanism. The rate differential served both to offset the advantage AT&T had by virtue of its superior interconnection arrangements before implementation of equal access, and to establish reasonable transitional rates during equal access implementation.^{59/}

^{57/} These transitional rules covered property placed in service after December 31, 1985 but subject to a contract that was binding prior to that date and facilities that were substantially under construction, but not complete, prior to December 31, 1985. TRA § 201(b)(1).

^{58/} Exchange Network Facilities, 71 FCC 2d 440 (1979).

^{59/} See, MTS/WATS Market Structure, 97 FCC 2d 834, 858-63 (1984).

The Commission's decision in the early 1980s to deregulate customer premises equipment ("CPE"), and eventually inside wire,^{60/} coincided with concerns of a telephone industry bias, reinforced by the application of rate-of-return regulation, toward capitalization of items which more properly should be expensed. As part of the Commission's ongoing review of its regulatory policies, the Commission determined that CPE should be deregulated and removed from the AT&T/Bell System and the Independent LECs' ratebases.^{61/} While the deregulation of new CPE could be accomplished relatively easily, immediate detariffing of the embedded base of regulated CPE would have had a significant impact on rates.^{62/} The Commission convened a proceeding to address the issues of capital recovery and asset valuation, transition to an unregulated CPE environment, and the appropriate time period to remove embedded CPE investment from carrier ratebases. While the Commission had more limited discretion to fashion a transition for detariffing of Bell System CPE in light of the divestiture, the Commission adopted a transition framework for

60/ In the Matter of Detariffing the Installation and Maintenance of Inside Wiring, Second Report and Order, 59 RR 2d 1143 (1986); Third Report and Order, 7 FCC Rcd 1334 (1992).

61/ Amendment of Section 64.702 of the Commission's Rules (Second Computer Inquiry), 77 FCC 2d 384, recon., 84 FCC 2d 50 (1980), further recon., 88 FCC 2d 512 (1981), aff'd sub nom., Computer & Communications Industry Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), cert denied sub nom., Louisiana Pub. Serv. Comm'n v. FCC, 461 U.S. 938 (1983).

62/ Embedded CPE included all the CPE owned by a carrier, including inventory, that was tariffed or subject to the federal-state jurisdictional separations process as on January 1, 1983. Detariffing of CPE, 99 FCC 2d 354, 355 (1984).

Independent LECs, permitting these carriers to develop state specific plans that ensured that CPE would be detariffed by January 1, 1987.^{63/} The Commission observed that:

[b]y providing a flexible framework for detariffing the embedded CPE owned by Independent companies, this Order enables an easier transition which may provide more specific relief for the circumstances facing particular Independents.^{64/}

The regulatory changes associated with CPE and inside wire had enormous price tags, an estimated \$10 billion for CPE, and an overall impact for expensing inside wire (or station connections) of approximately an equivalent amount. Notably, telephone stockholders were not asked to bear the \$20 billion cost of changing the regulatory treatment either for CPE or inside wire. Telephone companies were given ten years to amortize fully the embedded, capitalized base of inside wire costs on their books.^{65/} They also were given a concurrent four-year period to phase in full expensing at 25 percent a year for four years.^{66/}

This transitional approach benefitted consumers as well as telephone companies, because expensing on a flash-cut basis would have sharply increased

^{63/} All embedded CPE held by the Bell Operating Companies ("BOCs") was transferred to AT&T pre-divestiture and was detariffed on January 1, 1984, coincident with the Bell System divestiture.

^{64/} Detariffing of CPE, 99 FCC 2d at 375.

^{65/} Amendment of Part 31, First Report and Order, 85 FCC 2d 818, 829 (1981).

^{66/} Id. at 828.

regulated revenue requirements and rates.^{67/} The increase in rates, while somewhat offset by decreases in the ratebase, was largely the result of spreading the costs over a seven-year average life for station connections to the immediate expensing of the activity and recovery of the cost in the current period.

The Commission has employed transitional mechanisms in regulated carrier accounting as well. In 1988 the Commission adopted a five-year amortization policy to address a continuing imbalance of LEC depreciation reserve deficiencies.^{68/} The Commission determined that its action was warranted to ensure that its depreciation policies "continue to provide a balance between the rates charged consumers and the timely recovery by carriers of the capital devoted to providing service."^{69/} The Commission concluded that a reasonable response to the industry's reserve problems would be a one-time, five year amortization of the imbalances in the LEC's depreciation reserves.

These examples illustrate that the Commission often has balanced consumer and investor interests by adopting transition mechanisms. Comcast submits that the

^{67/} Similarly, the immediate recognition of acquisition costs or other shareholder investments in cable systems could have had a dramatic effect on rates.

^{68/} Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers, 3 FCC Rcd 984 (1988) ("Amortization of DRI"). As the Commission notes in its Order, a substantial reserve deficiency developed in the late 1960s, and though Commission action helped ameliorate this problem, "the progress in decreasing the reserve deficiency has been uneven." Id. Thus, the Commission proposed and later adopted a method to amortize the industry's reserve deficiency over a five-year period. See generally, Id.

^{69/} Id.

Commission must do so once again to ameliorate harm to consumers and cable operators that results from the transition to regulation.

B. Historical Review of Newly Regulated Industries Confirms Consistent Use of Fair Market and Other Similar System Valuation Methodologies.

While the use of the depreciated original cost ratebase has become common place, review of public utility history reveals that industries initially subjected to regulation typically received a return based on either system replacement cost or fair market value. Prior to Hope, courts fixed the ratebase of a utility based on the fair value of the property placed in service.^{70/}

It was not until Justice Brandeis' concurring opinion in the Southwestern Bell case that courts began to challenge the use of a fair value measure. As Justice Brandeis stated:

It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge; and thus, the vicious circle would be encountered.^{71/}

70/ See, Smyth v. Ames, 169 U.S. 466 (1898); Minnesota Rate Cases (Simpson v. Shepard), 230 U.S. 352 (1913) ("The property is held in private ownership, and it is that property, and not the original cost of it, of which the owner may not be deprived without due process of law.").

71/ Missouri ex rel. Southwestern Bell Telephone Co. v. Public Serv. Commission, 262 U.S. 276, 287-88 (1923) (Brandeis, J., concurring).

As indicated by this passage, the shift from fair value to original cost, which was largely completed by the time of Hope,^{72/} was based on the lack of market information and the fact that the value of a regulated business is dependent on the rates which it is permitted to charge. The NPRM cites no instance of an industry that has been subject to initial rate regulation under an original cost regime. The proposals in the NPRM are therefore radical as well as unwise.

C. Cable Operators Must Be Allowed to Recover Investments in Intangible Assets.

The Commission is statutorily and constitutionally required to adopt rules in this proceeding that allow a cable operator to earn a reasonable rate of return on its investment in a cable system. To accomplish such a result, the Commission must allow an operator to include intangible assets in the ratebase in order to justify existing rates. If an operator can justify a rate that is higher than its existing rate, the operator then should be allowed to continue charging its existing rate and gain increases in the future in sufficient amounts to recover its net investment.^{73/}

^{72/} Fair value has not been completely rejected as the proper measure of the ratebase. As noted in Principles of Public Utility Rates, Bonbright, Daniels and Kamerschen (Public Utilities Reports 1989) ("Bonbright"), "the fair-value rule of ratemaking has not yet suffered its oft-anticipated complete demise. Indeed in several jurisdictions it has been restored to some measure of its earlier vigor" Bonbright at 231. Approximately a dozen states use some form of fair value measure. Id.

^{73/} This amortization adjustment will be referred to as a Z factor. As will be discussed in this section, the Z factor will be added to other external costs under the price cap regime adopted in the Report and Order.

1. Operators Must Be Allowed to Recover Their Total Investment in a System, Including Intangible Assets.

A purchaser of a cable system, when estimating the value of a system, bases its projections of revenue on a pricing policy that reflects the market's assessment of the value of the services offered. Because the present value of the projected cash flows invariably exceeds the book value of the tangible assets, the buyer knowingly pays for intangible assets which the seller created in the early years of its operation of the system.^{74/}

Three specific types of intangible assets typically have been identified with cable companies: (1) subscriber lists, (2) franchise value, and (3) going concern value.

a. Subscriber Lists.

In the cable television business, the inception and continuation of subscriber patronage results from quality of service and the type and quality of programs delivered by the cable television system rather than from any affinity for the cable

^{74/} Intangible assets arise in nearly every purchase transaction involving a commercial entity. When an arms length transaction occurs between a willing buyer and a willing seller, the purchase price represents fair market value of that business. Purchase prices are determined by expectations of cash flows. The cash flows expected will be derived from the intangible as well as the tangible assets of the acquired enterprise. The buyer, in effect, agrees to pay for not only the tangible fixed assets of the enterprise, but also willingly pays for the value of other aspects, referred to as intangible assets.

television company or the policies of its management. Thus, viewers cannot be relied upon to continue their subscriptions unless programming is attractive.

The subscribers to cable service are the primary source of revenues for the operator. They generate a consistent and predictable source of revenue from subscription fees. The demographics of the subscriber base will determine the extent of usage of cable services and will determine the revenues available from advertisers attempting to reach certain audiences.

A critical factor in valuing subscriber lists is the average turnover rate of subscribers. Subscriber relationships terminate within certain reasonably stable and predictable patterns, due mainly to changes in the circumstances of individual subscribers, e.g., relocation to other regions, product dissatisfaction, etc. Industry analysts perform studies to determine the average length of time that subscribers will continue to buy the services of the cable company. They then estimate the cash flows assignable to each subscriber. From this data, the cash flows directly attributable to having a subscriber in place can be determined. The present value of these cash flows on the purchase date is used to determine the value of the subscriber list.^{75/}

^{75/} The Supreme Court has recognized that a subscriber list may be a depreciable asset separate from goodwill. See, Newark Morning Ledger Co. v. U.S., 61 U.S.L.W. 4313 (U.S. April 20, 1993).

b. Franchise Value.

Cable television operations are conducted pursuant to the terms of a franchise granted by the local governing body of the area served. Such local franchises are non-exclusive,^{76/} generally non-transferable without consent of the local authority, and subject to conditions and limitations. These provisions frequently include: payment of fees to the granting authority, determined as a percentage of gross revenues as limited by the Commission; limitations on installation and/or service charges; conditions of service including provision of a minimum number of channels; maintenance of insurance and/or indemnity against specified risks; and a requirement that construction of facilities be completed within a specified time period. Failure to comply with such conditions and limitations may result in termination of the authority.

A cable operator cannot be certain its franchise will be renewed upon expiration. If the operator is able to obtain a new franchise for the same area, the new agreement may require the provision of certain programming or the replacement of a portion of the company's facilities. Under these circumstances, therefore, no inherent renewal advantage attaches to the existing franchise agreement.

The franchise value is determined by taking the total returns expected by the cable system and reducing them by the returns expected on the tangible assets, and

^{76/} Franchise provisions that purport to grant an exclusive franchise are preempted by the Communications Act. 47 U.S.C. § 541(a)(1).

the other identifiable intangible assets. The returns expected beyond the returns on these other assets can only be realized by having a franchise right to provide the service and receive a profit.

c. Going Concern Value.

Going concern value is that element of intangible value which an enterprise possesses when it is established, doing business and earning profits up to a fair rate of return on its investment. Indications that a business possesses going concern value include the existence of in-place operational facilities and management and service personnel, and a reasonable expectancy that recent levels of operations will continue regardless of changes in ownership.

Assigning a value to the going concern element is monetary recognition that an enterprise may experience an initial start-up period in which the return achieved on investment is below the fair return experienced by the industry. By acquiring an existing system, the purchaser avoids the net operating and economic losses which would usually be associated with the start-up of a new cable television system.

Therefore, a measure for determining going concern value is the estimated amount of avoided start-up costs. These costs would consist of (1) the excess of operating expenses over revenue during the initial development of the cable system and (2) the fair return on net investment that would not be earned until the system achieves earnings up to fair rate of return. A traditional public utility can expect to earn at least some return on its investment from the first day of operation because

when the facility is brought on-line, it has essentially 100 percent penetration of the market. A cable system starts with no penetration, and it can take several years for penetration to reach a sufficient level to allow a return on investment. As such, the going concern value is predictably higher for a cable system than a traditional public utility.

2. Justification of Initial or Current Rates.

In the NPRM, the Commission seeks comment on its proposal to exclude the value of "excess acquisition costs" from the ratebase of operators that seek to justify initial rates. The so-called "excess" acquisition costs that the Commission proposes to exclude represent an operator's prudent investment in intangible assets. For the reasons discussed more thoroughly in the previous subsection, exclusion of intangible assets from the ratebase will result in a rate that is confiscatory, particularly for newly acquired systems.

To avoid such a result, the Commission must allow an operator to charge a rate sufficient to earn a return on the operator's total investment in a system, including intangible assets. For purposes of justifying initial or current rates, an operator must be allowed to earn a return on a ratebase that includes the value of all assets, including intangible assets. Any other approach will unreasonably deny an operator a return on its investment in a system in violation of the 1992 Cable Act and the Constitution.

3. Adjustment in Subsequent Periods.

In many cases, an operator that includes intangible assets in the ratebase will be able to justify a rate that is much higher than its existing rate. This difference reflects the decision of many operators to charge a rate that is attractive to customers, even if that rate does not fully recover costs in the short term. Rather than allowing operators to increase rates to the highest level that can be justified, Comcast submits that operators should be allowed to add a Z factor to their price cap increases over the course of the recovery period.

The Z factor represents an adjustment for the recovery of and an adequate return on an operator's net investment in tangible and intangible assets which would not otherwise be recovered under the price cap rules. The Z factor would be calculated at the time the operator makes its initial rate justification and should be included in addition to "external costs" for purposes of calculating an operator's annual rate increase under the price cap regime adopted in the Report and Order.

Using a Z factor as a mechanism achieves the proper balance of consumer and investor interests. Consumers benefit from this proposal because an operator is prevented from taking a major rate increase, even though such an increase may be justified, yet investors are allowed to recover their entire investment and earn a reasonable return on their net investment, over a reasonable period of time. The Z factor also satisfies the congressional directive that the Commission adopt regulations

that are easy to administer because it allows the operator to recover its entire investment in a system while only requiring a single cost showing.

V. THE COMMISSION SHOULD NOT ADOPT AN OVERALL INDUSTRY RATE OF RETURN.

A. The Commission Is Re-evaluating Use of a Unitary Rate of Return for Rate Regulated LECs.

The Commission recommends establishing a single rate of return for all cable operators to be used for the "purpose of setting rates based on a cost-of-service showing".^{77/} The Commission has previously recognized the problems associated with prescribing a unitary rate of return. For example, the Commission's rules permit LECs the opportunity to seek rates of return different from the unitary rate prescribed by the Commission and recognize that in some cases a unitary overall rate of return may be "so low as to be confiscatory because it is outside the zone of reasonableness for the individual carrier's required rate of return for exchange services."^{78/} The Commission is currently evaluating alternatives to prescribing a unitary rate of return for rate regulated LECs whose capital structures are increasingly diverse.^{79/} Comcast submits that application of a unitary rate of return to an

^{77/} NPRM at ¶ 46.

^{78/} 47 CFR § 65.101. This approach was reconfirmed by the Commission last year. Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Process, 7 FCC Rcd 4688, 4694 (1992).

^{79/} Id.

industry as diverse as cable television would result in rates that are confiscatory for many systems.

B. Adoption of a Unitary Rate of Return Is Inappropriate for the Cable Industry.

The initial cost of service showing captures previously unregulated companies at a point in time and at a variety of different stages in recovery of their investments in various franchises. Prices for cable systems have not been set in strict relationships to costs as they have been by telephone companies in the past. Neither have rates been averaged nor have deliberately sanctioned cross-subsidies been introduced to promote universal service. Cable operators have not limited or averaged their risks by a pooling of revenues and reimbursement mechanisms as telephone companies have historically.

The cost of capital for a cable system, at this point in time, is not an average or approved ratio built into a revenue requirement and translated into a variety of different rates for diverse services. The cost of capital for the cable industry is a complex mix of debt cost coverage and some return on investment which will occur over time in accordance with the business plans of the operator and market reaction.

Given the diverse capital structure of the cable industry, adoption of a single rate of return cannot accurately reflect any individual operator's cost of capital. For the initial cost of service showing, which is designed to justify current rates, the internal rate of return developed and used by the operator in conjunction with its

acquisitions should be the target return. While this return may be higher than the return an operator currently earns it will only be used to justify existing rates, and not to increase rates at this time.

This proposed rate-of-return methodology, in combination with the Z factor, will allow cable operators to earn a reasonable rate of return without significant initial rate increases. This approach avoids the need for operators to make cost showings in subsequent periods because price cap increases (including the Z factor) should eventually allow an operator to recover its entire investment in a system. This is consistent with the Congressional directive to establish regulations that are easy to administer.

The foregoing demonstrates why imposing a unitary rate of return at this time would be both problematic and of little real benefit to cable subscribers. The Commission expressed concern that it would "not be possible, as a practical matter" to establish system, or company, specific return ratios.^{80/} Even assuming, arguendo, the validity of the Commission's concerns, the 10 percent to 14 percent (after taxes) return ratios proffered by the NPRM would be woefully inadequate as a means to sustain the minimum needs of individual systems. The flaws in the Commission's conclusions reflect its reliance upon non-comparable businesses. An analysis of a comparable earnings approach by AUS Consultants demonstrates that the composite pre-tax overall cost of capital for cable systems ranges from a low of

^{80/} NPRM at ¶ 46.

17.3 percent to a high of 20.5 percent.^{81/} AUS Consultants recommend use of an 18.9 percent ratio.

VI. THE COMMISSION SHOULD ADOPT STREAMLINING PROPOSALS.

To reduce the administrative burdens on all interested parties as mandated by the 1992 Cable Act, the Commission should adopt an alternate method by which cable operators can justify rates above benchmark levels. In the NPRM, the Commission seeks comment on what types of streamlining alternatives would be viable.^{82/} The Commission proposes several methods, including a streamlining method in which operators could document key cost factors, financial characteristics, or other combinations of factors to justify rates.^{83/} Under such a scheme, an operator only would be required to justify excess costs in specific areas, such as acquisition costs, to demonstrate that its rates are not unreasonable. Comcast supports this proposal.

The burden of engaging in a full blown analysis might discourage some operators from justifying reasonable, above-benchmark rates. If only certain identifiable factors were evaluated, the financial and administrative burdens on cable operators and regulatory authorities would be greatly reduced. For example, as discussed below, an operator's above-benchmark rate may be attributable to new,

^{81/} Comcast has attached the rate-of-return recommendations of AUS Consultants to these comments.

^{82/} NPRM at ¶ 71-72.

^{83/} NPRM at ¶ 73.

undepreciated equipment costs, or other system improvements. In such cases, those specific costs and the circumstances surrounding increases in those costs can be analyzed on an individual basis.

A. A Streamlining Alternative Must Permit Operators to Demonstrate that Existing Rates Are Reasonable.

The Commission seeks comment on whether any streamlining standards it adopts should permit operators to maintain existing rates without a cost showing.^{84/} Comcast supports this suggestion, however, the specific recommendations proposed by the Commission are not necessary under the rate formula proposed by Comcast. For example, the Commission suggests that initial rates could be considered reasonable if they are no higher than 1986 rates adjusted for inflation and a productivity offset.^{85/} Though this is a good measure of the rate for certain cable systems, it does not account for all exogenous costs, including the various intangible costs of acquiring systems, and thus may produce lower than reasonable rates.

Any viable method to justify existing rates must account for the costs of past investments. Thus, even using past regulated rates as the Commission suggests,^{86/} existing rates would rarely be justified under the Commission's proposed alternatives.

^{84/} NPRM at ¶ 71.

^{85/} NPRM at ¶ 71. There is no empirical evidence to support a productivity offset in the cable industry at this time. Moreover, it would be especially inappropriate to apply a productivity offset to those cable operators who justify their initial rates because their rates would already be subject to the one year freeze Comcast proposed.

^{86/} NPRM at ¶ 71.

B. Costs of System Upgrades, Including Increases in Channel Capacity, Need Not Be Justified Via Cost Showings.

An abbreviated showing is consistent with the Commission's proposal to treat separately prospective capital expenditures to improve the quality of service or upgrade a system.^{87/} These costs are not reflected in the Commission's benchmark and price cap system, which only permits increases for taxes, franchise fees, PEG costs, retransmission consent fees, and programming costs.^{88/} System upgrades and improvements are a regular cost of doing business, and are necessary to compete effectively and provide state-of-the-art service to subscribers. Optimally, these costs should be passed through routinely, as it is a stated goal of the 1992 Cable Act to ensure expansion of cable systems when economically justified.^{89/} However, if a cost showing must be made, the Commission's procedures should be relaxed.

The Commission's current benchmark system discourages expansion in channel capacity as well as other system improvements.^{90/} If the Commission decides not to permit pass-throughs of such costs, it should not require operators to submit cost justifications for such expenses. A "middle tier" or "abbreviated" showing would be

^{87/} NPRM at ¶ 75.

^{88/} 47 C.F.R. § 76.922(d).

^{89/} 1992 Cable Act § 2(b)(3). The rules, as currently formulated, appear to require almost all operators that upgrade their systems to submit an extensive cost showing.

^{90/} In its rate Report and Order, the Commission recognized the possibility that failure to permit pass-throughs of system improvements may "thwart[] the development of new technologies and services." Report and Order at n.608.